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TAGS: ECON PGOV EFIN BR ELAB
SUBJECT: BRAZIL'S AUTO SECTOR'S SUCCESS TO BE TESTED

REF: SAO PAULO 630; BRASILIA 141; SAO PAULO 531

¶1. (SBU) SUMMARY: In a largely successful effort to mitigate the worst impact of the global financial crisis, the Brazilian government provided tax breaks for industrialized products (IPI) at the end of 2008 to boost Brazil's auto sector. As a result, the sector has served as one of the engines in Brazil's quick economic recovery as tax breaks and extra liquidity in credit market spurred record car sales this year. The auto sector's near-term strength, however, will be tested in the next few months as the tax incentive phases out and exports remain stagnant. The outlook over the longer term remains bright as demand among Brazil's expanding middle class (ref A) increases and international investors focus on Brazil as a growth market. END SUMMARY

GOVERNMENT INCENTIVE DRIVES DOMESTIC DEMAND

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¶2. (SBU) With the onset of the global financial crisis, in September 2008 Brazil's auto sector suffered its first monthly sales decline in five years, as sales nationwide fell 11 percent. Production dropped about 32 percent the following month as several auto companies instituted mandatory vacations to slow output. Concerned that companies' temporary measures could become permanent layoffs, the Government of Brazil (GoB) stepped in with a USD 3.5 billion aid package for the auto industry. The package included a temporary suspension of the industrial products (IPI) tax on small cars (from 7 percent to zero) and halving the tax for large cars (from 13 percent to 6.5 percent) as well as funding for banks to increase car loans (ref B). [NOTE: According to contacts from the National Motor Vehicle Manufacturers Association (ANFAVEA) as well as General Motors, about 70 percent of domestic vehicle sales are funded by banks through car loans. END NOTE]. The GoB incentive program generated immediate effects as automobile output rose 92 percent and sales climbed 1.5 percent in January 2009.

¶3. (U) As sales increased and stocks of unsold vehicles dwindled to manageable levels, the GoB decided to extend the temporary tax cut from March to the end of June. This move along with added liquidity in the credit market and improvements in economic

conditions (ref C) lured consumers to showrooms. In June car sales reached a record-high of 300,174 units--a 17 percent increase from June 2008. Hoping to maintain the car sales momentum, the GoB extended the full tax break until September 30, with an incremental reduction of the tax over the rest of the year. Auto companies ramped up production in August and September in anticipation of the tax break expiration, which fueled a 20 percent increase in September sales. From January-September 2009, Brazil's auto industry posted car sales growth of 5.5 percent reaching 2.2 million units over the same period the previous year.

----------SHORT TERM TESTS REMAIN

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¶4. (SBU) While the domestic auto sector has recovered in recent months, auto exports have remained stagnant with exports still down over 40 percent from the previous year. [NOTE: Brazilian auto exports represent only 10 percent of total auto production this



year, compared to 15 percent in 2008. END NOTE]. The lag reflects an overall slower recovery in global demand for Brazilian manufactured goods. Trade analyst Frederico Marchiori from the Federation of Industries of Sao Paulo (FIESP) told Econoff he expects this trend to prevail for the rest of 2009.

¶5. (SBU) Likewise, despite the government's intent to minimize the impact of the tax break expiration, by gradually increasing the tax rate on small cars to 1.5 percent for the month of October, 3 percent for November, and to 5 percent for December, domestic sales are likely to slacken in the near-term. Jackson Schneider, president of ANFAVEA, publicly stated that the top three international car makers, Volkswagen, Fiat and General Motors, expect a slow-down in sales once the tax break ends. In an October 9 meeting with Econoff, ANFAVEA Executive Director Paulo Sotero dismissed the likelihood of yet another extension of the tax break, a view echoed by GOB contacts in Brasilia.

LONG TERM DOMESTIC GROWTH AHEAD...

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¶6. (SBU) Over the longer term, growing domestic prosperity driven by high commodity prices and low inflation over the last five years has fostered an expanding Brazilian middle class eager to take advantage of improving credit terms and buy automobiles. ANFAVEA Technical Director Aurelio Santana told Econoff they expect the person-per-car ratio in Brazil of eight to one to fuel growing demand for cars for years to come. General Motors Brazil Vice President Pedro Luiz Diaz echoed this view, recently telling the Consul General during a visit to the GM plant in Sao Caetano do Sul, that Brazil is the auto industry's second most profitable operation worldwide after China.

¶7. (SBU) Small, compact, and relatively inexpensive cars remain the top choice amongst Brazilians. In August 2009 compact car sales accounted for 55 percent of total vehicle sales, generating interest among international auto firms to boost their investment in small vehicle models. GM Brazil official Pedro Bentancourt told us the company just launched its new compact vehicle "Agile" in Brazil, a $400 million investment, based on continuing high demand in this market segment. Overall, Foreign Direct Investment (FDI) in the auto sector is estimated to reach 24 percent of total

industry investment in 2009, up from 20 percent last year, according to a Morgan Stanley research.

...Attracting Chinese Investment

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¶8. (SBU) Chinese auto companies Chery Automobile and Jianghuai Automotive (JAC) are contemplating entering the Brazilian auto market. According to ANFAVEA, Chinese firms see Brazil not only as an attractive and expanding market, but also as a strategic location to supply vehicles to the rest of Latin America. ANFAVEA Executive Director Sotero said the strategy of these Chinese companies is to set up factories in Brazil in the next two years to avoid paying the 35 percent vehicle import tariff and build consumer loyalty for locally produced models.



¶9. (SBU) Chinese companies' lower cost structure makes the Brazilian market even more attractive. For example, JAC produces a compact car that sells in China for approximately USD 8,300 (NOTE: Calculation based on current exchange rate at USD 1 equivalent to R$1.8. END NOTE). Chery Automobile is planning to produce an even smaller vehicle that would cost only USD 4,900 in China. Our ANFAVEA contacts tell us that Chinese companies have been studying the Brazilian market for some time. Given the steady increase in Brazilian domestic demand, they suggest now could be an opportune time for Chinese firms to enter the Brazilian market.

COMMENT

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¶10. (SBU) According to data from Brazil's Applied Economic Research Institute (IPEA), the GoB's temporary tax break kept the auto industry from shedding thousands of high paying jobs, and bolstered production of 110,000 additional cars. On the downside, the tax cuts inevitably eroded GoB revenues and may have also helped industry avoid some cost-cutting. The immediate test will be how the sector fares once the favorable tax environment disappears. Fortunately, the long-term outlook for the sector remains bright as domestic demand is expected to increase and more international investors view Brazil as a growth market.
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